

September 5, 1989

FTB Notice 89-493
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Re: Partnerships - Guaranteed Payments
Nonresident Partners' California Source Portion,
Payroll Factor Computation

Advice has been requested as to the proper allocation of guaranteed payments to nonresident partners as income from California sources and the proper amount to be included in the payroll factor of a partnership engaged in business within and without California.

Holdings

1. Guaranteed payments should be treated as a distributive share of partnership income. Under 18 Cal. Code Regs. §17951-4(f), the individual partner will treat 60% of both the distributive share [if any] and guaranteed payment as salary, to be sourced wherever the services to the partnership are rendered. The remaining 40% of distributive share and guaranteed payment will be apportionable in accordance with the apportionment factors of the partnership.

2. Guaranteed payments should be treated for payroll factor purposes as distributive shares and included as provided in 18 Cal. Code Regs. §17954-4(f). In the case of a nonresident partner who renders services to the partnership, 60% of that partner's distributive share, including any guaranteed payments, is included in the payroll factor denominator. The "deemed salary" portion of the nonresident partner will be included in the California numerator only to the extent that the partner performs services in California.

Analysis

General Discussion

18 Cal. Code Regs. §17951-4(f) recognizes that the income generated by a professional partnership is partially attributable to the personal efforts of the partners and partially attributable to other factors such as partners' capital contributions and the activities of nonpartner employees.

Logically, the portion of the income produced by the individual

efforts of the partners should be treated, both to the partnership and to the individual partner, as compensation for services. It should be included in the payroll factor denominator and in the numerator of the state where the services were rendered, and it should be treated as income sourced in the state where the services were performed.

The remaining portion of each partner's income, attributable to partnership capital and the efforts of nonpartner employees, should logically be treated as a share of the profits from the partnership's business activities generally. This portion should therefore be apportioned according to the partnership's property, payroll and sales (revenue) factors.

Although guaranteed payments have some characteristics of salary, notably that they are deductible by the partnership and must be taken into income by the partner when paid, they are regarded as a partner's distributive share of ordinary income for most purposes (see Treas. Reg. §1.707(c).) This recognizes the fact that the amount paid as a guaranteed payment often reflects more than the market value of services rendered to the partnership by that individual partner.

Issue 1 - Sourcing of Guaranteed Payments

Revenue and Taxation Code §17854, which provides that guaranteed payments to a nonresident partner shall be gross income from sources within this state, must be read in conjunction with Revenue and Taxation Code §17041(b), which imposes a tax on income of nonresidents which is derived from California sources, and Revenue and Taxation Code §17951, which limits the gross income of nonresidents to California source income.

18 Cal. Code Regs. §17951-1(b) explains that the gross income of nonresidents who are members of partnerships includes the [partner's] distributive share of partnership income [only] to the extent that the [partner's] distributive share is derived from California sources, including amounts received by a nonresident partner as payments for services or use of capital (i.e. guaranteed payments.)

Therefore, that portion of a guaranteed payment which is treated either as compensation for services performed in California or as the apportioned California share of partnership income will be treated as California source income to a nonresident partner.

18 Cal. Code Regs. §17951-4(f) establishes a bright-line test for nonresidents engaged in the practice of a profession (such as the practice of law), treating 60% of the income as

compensation for services rendered, and 40% as income derived from other partnership activities. In the case of a partner who does not render professional services to the partnership, 100% is treated as income derived from other partnership activities.

The second part of the Example in 18 Cal. Code Regs. §17951-4(f) shows the proper computation of a nonresident partner's income from California sources.

Issue 2 - Treatment of Guaranteed Payments in Payroll Factor

As explained above, for payroll factor purposes, guaranteed payments should be treated as distributive shares and included in the payroll factor as shown in 18 Cal. Code Regs. §17951-4(f). This treatment recognizes that a portion (40% under the bright-line test) of the guaranteed payment may be attributable either to partnership capital, in which case it should not be included in the factor at all, or to the activities of nonpartner employees, in which case it would be reflected by the inclusion of the salaries of those employees in the appropriate numerator.

DRAFTING INFORMATION

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